Reading 46: Market Efficiency

Question #1 of 34

Question ID: 415241

Which of the following statements *least likely* describes the role of a portfolio manager in perfectly efficient markets? Portfolio managers should:

- ✗ **A)** construct diversified portfolios that include international securities to eliminate unsystematic risk.
- ✓ **B)** quantify client's risk tolerance, communicate portfolio policies and strategies, and maintain a strict buy and hold policy avoiding any changes in the portfolio to minimize transaction costs.
- ✗ **C)** construct a portfolio that includes financial and real assets.

Explanation

A portfolio manager should quantify each client's risk tolerance and communicate portfolio policies and strategies. However, portfolio managers should monitor client's needs and changing circumstances and make appropriate changes to the portfolio. Adhering to a strict buy and hold policy would not be in the client's best interest. Portfolios need to be rebalanced and changed to meet client's changing needs.

References

Question From: Session 13 > Reading 46 > LOS e

Related Material:

- Key Concepts by LOS

Question #2 of 34

Question ID: 415232

Which of the following statements about market efficiency is *least* accurate?

- ✗ **A)** The strong-form EMH assumes cost free availability of all information, both public and private.
- ✓ **B)** The weak-form EMH suggests that fundamental analysis will not provide excess returns while the semi-strong form suggests that technical analysis cannot achieve excess returns.
- ✗ **C)** The semi-strong form EMH addresses market and non-market public information.

Explanation

The weak-form EMH suggests that *technical* analysis will not provide excess returns while the semi-strong form suggests that *fundamental* analysis cannot achieve excess returns. The weak-form EMH assumes the price of a security reflects all currently available *historical* information. Thus, the past price and volume of trading has no relationship with the future, hence technical analysis is not useful in achieving superior returns.

The other choices are correct. The strong-form EMH states that stock prices reflect all types of information: market, non-public market, and private. No group has monopolistic access to relevant information; thus no group can achieve excess returns. For these assumptions to hold, the strong-form assumes perfect markets - information is free and available to all.

References

Question From: Session 13 > Reading 46 > LOS d

Related Material:

- Key Concepts by LOS

Question #3 of 34

Question ID: 415238

Which of the following statements concerning market efficiency is *least* accurate?

✓ **A)** Market efficiency assumes that individual market participants correctly estimate asset prices.

✗ **B)** If weak-form market efficiency holds, technical analysis cannot be used to earn abnormal returns over the long-run.

✗ **C)** Tests of the semi-strong form of the EMH require that security returns be risk-adjusted using a market model.

Explanation

Market efficiency does not assume that individual market participants correctly estimate asset prices, but does assume that their estimates are unbiased. That is, some agents will over-estimate and some will under-estimate, but they will be correct, on average.

References

Question From: Session 13 > Reading 46 > LOS e

Related Material:

- Key Concepts by LOS

Question #4 of 34

Question ID: 415251

The idea that uninformed traders, when faced with unclear information, observe the actions of informed traders to make decisions, is referred to as:

✓ **A)** information cascades.

✗ **B)** herding behavior.

✗ **C)** narrow framing.

Explanation

"Information cascades" refers to uninformed traders watching the actions of informed traders when making investment decisions. Herding behavior is when trading occurs in clusters, not necessarily driven by information. Narrow framing refers to investors viewing events in isolation.

References

Question From: Session 13 > Reading 46 > LOS g

Related Material:

- Key Concepts by LOS

Question #5 of 34

Question ID: 415228

Which of the following statements on the forms of the efficient market hypothesis (EMH) is *least* accurate?

✗ **A)** The semi-strong form EMH addresses market and non-market public information.

✓ **B)** The weak-form EMH states that stock prices reflect current public market information and expectations.

✗ **C)** The strong-form EMH assumes perfect markets.

Explanation

The weak-form EMH assumes the price of a security reflects all currently available *historical* information. Thus, the past price and volume of trading has no relationship with the future, hence technical analysis is not useful in achieving superior returns.

The other statements are true. The strong-form EMH states that stock prices reflect all types of information: market, non-public market, and private. No group has monopolistic access to relevant information; thus no group can achieve excess returns. For these assumptions to hold, the strong-form assumes perfect markets - information is free and available to all.

References

Question From: Session 13 > Reading 46 > LOS d

Related Material:

- Key Concepts by LOS

Question #6 of 34

Question ID: 415230

The strong-form efficient market hypothesis (EMH) asserts that stock prices fully reflect which of the following types of information?

✓ **A)** Public and private.

✗ **B)** Public, private, and future.

✗ **C)** Market.

Explanation

The strong-form EMH assumes that stock prices fully reflect all information from public and private sources.

References

Question From: Session 13 > Reading 46 > LOS d

Related Material:

- Key Concepts by LOS

Question #7 of 34

Question ID: 415234

Which of the following forms of the EMH assumes that no group of investors has monopolistic access to relevant information?

- ✗ **A)** Weak-form.
- ✗ **B)** Both weak and semistrong form.
- ✓ **C)** Strong-form.

Explanation

The strong-form EMH assumes that stock prices fully reflect all information from public and private sources. In addition, no group of investors has monopolistic access to information relevant to the formation of prices.

References

Question From: Session 13 > Reading 46 > LOS d

Related Material:

- Key Concepts by LOS

Question #8 of 34

Question ID: 598995

An investor who is more risk averse with respect to potential negative outcomes than potential positive outcomes *most likely* exhibits:

- ✓ **A)** loss aversion.
- ✗ **B)** mental accounting.
- ✗ **C)** conservatism.

Explanation

Loss aversion is exhibited by an investor who dislikes a loss more than he likes an equal gain. That is, the investor's risk preferences are asymmetric. Mental accounting refers to mentally classifying investments in separate accounts rather than considering them from a portfolio perspective. In behavioral finance, conservatism refers to a tendency to maintain one's prior views even in the presence of new information.

References

Question From: Session 13 > Reading 46 > LOS g

Related Material:

- Key Concepts by LOS

Question #9 of 34

Question ID: 415221

The measure of an asset's value that can *most likely* be determined without estimation is its:

- ✗ **A)** intrinsic value.
- ✗ **B)** fundamental value.
- ✓ **C)** market value.

Explanation

The current price of a traded asset is its market value. An asset's intrinsic or fundamental value is the price a rational investor with complete information about the asset would pay for it.

References

Question From: Session 13 > Reading 46 > LOS b

Related Material:

- Key Concepts by LOS

Question #10 of 34

Question ID: 415218

The implication of efficient capital markets and a lack of superior analysts have led to the introduction of:

- ✗ **A)** futures options.
- ✓ **B)** index funds.
- ✗ **C)** balanced funds.

Explanation

An index fund is designed to duplicate the composition of a specific index series or market segment. There is a strong argument suggesting that portfolio managers cannot beat the market after fees, therefore an index fund should be used to try to match the market.

References

Question From: Session 13 > Reading 46 > LOS a

Related Material:

- Key Concepts by LOS

Question #11 of 34

Question ID: 415240

In a perfectly efficient market, portfolio managers should do all of the following EXCEPT:

- ✗ **A)** quantify their risk and return needs within the bounds of the client's liquidity, income, time horizon, legal, and regulatory constraints.
- ✓ **B)** diversify to eliminate systematic risk.
- ✗ **C)** monitor their client's needs and circumstances.

Explanation

Portfolio managers cannot eliminate systematic risk (i.e., market risk) thru the use of diversification. Portfolio managers should try to eliminate unsystematic portfolio risk.

References

Question From: Session 13 > Reading 46 > LOS e

Related Material:

- Key Concepts by LOS

Question #12 of 34

Question ID: 415243

David Farrington is an analyst at Farrington Capital Management. He is aware that many people believe that the capital markets are fully efficient. However, he is not convinced and would like to disprove this claim. Which of the following statements would support Farrington in his effort to demonstrate the limitations to fully efficient markets?

- ✗ **A)** Stock prices adjust to their new efficient levels within hours of the release of new information.
- ✓ **B)** Processing new information entails costs and takes at least some time, so security prices are not always immediately affected.
- ✗ **C)** Technical analysis has been rendered useless by many academics who have shown that analyzing market trends, past volume and trading data will not lead to abnormal returns.

Explanation

If market prices are efficient there are no returns to the time and effort spent on fundamental analysis. But if no time and effort is spent on fundamental analysis there is no process for making market prices efficient. To resolve this apparent conundrum one can look to the time lag between the release of new value-relevant information and the adjustment of market prices to their new efficient levels. Processing new information entails costs and takes at least some time, which is a limitation of fully efficient markets.

References

Question From: Session 13 > Reading 46 > LOS e

Related Material:

- Key Concepts by LOS

Question #13 of 34

Question ID: 415244

The opportunity to take advantage of the downward pressure on stock prices that result from end-of-the-year tax selling is known as the:

- ✗ **A)** end-of-the-year effect.
- ✓ **B)** January anomaly.
- ✗ **C)** end-of-the-year anomaly.

Explanation

The January Anomaly is most likely the result of tax induced trading at year end. An investor can profit by buying stocks in December and selling them during the first week in January.

References

Question From: Session 13 > Reading 46 > LOS f

Related Material:

- Key Concepts by LOS

Question #14 of 34

Question ID: 415235

The semi-strong form of the efficient market hypothesis (EMH) asserts that stock prices:

- ✗ **A)** fully reflect all relevant information including insider information.
- ✗ **B)** fully reflect all historical price information.
- ✓ **C)** fully reflect all publicly available information.

Explanation

The semi-strong form of the EMH asserts that security prices fully reflect all publicly available information. This would include all historical information. The weak form relates to historical information only. The strong form relates to public and private information.

References

Question From: Session 13 > Reading 46 > LOS d

Related Material:

- Key Concepts by LOS

Question #15 of 34

Question ID: 415226

An increase in which of the following factors would *most likely* improve a market's efficiency?

- ✓ **A)** Number of participants.
- ✗ **B)** Restrictions on short selling.
- ✗ **C)** Bid-ask spreads.

Explanation

As the number of market participants increases, the speed at which markets adjust to new information is likely to increase. Restrictions on short selling limit the ability of arbitrage to correct pricing anomalies. High bid-ask spreads increase transaction costs and decrease efficiency.

References

Question From: Session 13 > Reading 46 > LOS c

Related Material:

- Key Concepts by LOS

Question #16 of 34

Question ID: 415219

In an informationally efficient market:

- ✓ **A)** buying and holding a broad market portfolio is the preferred investment strategy.

- ✗ **B)** share prices adjust rapidly when companies announce results in line with expectations.
- ✗ **C)** the conditions exist for active investment strategies to achieve superior risk-adjusted returns.

Explanation

If financial markets are informationally efficient, active investment strategies cannot consistently achieve risk-adjusted returns superior to holding a passively managed index portfolio. In addition, a passive investment strategy has lower transactions costs than an active management strategy. Share prices should not adjust when a company announces results in line with expectations in an informationally efficient market, because the market price already reflects the expected results.

References

Question From: Session 13 > Reading 46 > LOS a

Related Material:

- Key Concepts by LOS

Question #17 of 34

Question ID: 415222

A stock is said to be undervalued if its market price is:

- ✗ **A)** less than its book value.
- ✗ **B)** greater than its intrinsic value.
- ✓ **C)** less than its intrinsic value.

Explanation

A security with a market price less than its intrinsic value is undervalued.

References

Question From: Session 13 > Reading 46 > LOS b

Related Material:

- Key Concepts by LOS

Question #18 of 34

Question ID: 415246

Which of the following statements *best* describes the overreaction effect?

- ✓ **A)** Low returns over a three-year period are followed by high returns over the following three years.
- ✗ **B)** High returns over a one-year period are followed by low returns over the following three years.
- ✗ **C)** High returns over a one-year period are followed by high returns over the following year.

Explanation

The overreaction effect refers to stocks with poor returns over three to five-year periods that had higher subsequent performance than stocks with high returns in the prior period. The result is attributed to overreaction in stock prices that reverses over longer periods of time. Stocks with high previous short-term returns that have high subsequent returns show a momentum effect.

References

Question From: Session 13 > Reading 46 > LOS f

Related Material:

- Key Concepts by LOS

Question #19 of 34

Question ID: 415242

Which of the following is a limitation to fully efficient markets?

✓ **A)** The gains to be earned by information trading can be less than the transaction costs the trading would entail.

✗ **B)** There are no limitations to fully efficient markets because the trading actions of fundamental and technical analysts are continuously keeping prices at their intrinsic value.

✗ **C)** Information is always quickly disseminated and fully embedded in a security's prices.

Explanation

Market prices that are not precisely efficient can persist if the gains to be made by information trading are less than the transaction costs such trading would entail.

References

Question From: Session 13 > Reading 46 > LOS e

Related Material:

- Key Concepts by LOS

Question #20 of 34

Question ID: 415249

Investor overreaction that has been documented in securities markets is *most likely* attributable to investors exhibiting:

✓ **A)** loss aversion.

✗ **B)** conservatism.

✗ **C)** risk aversion.

Explanation

Loss aversion refers to the tendency for investors to dislike downside risks more than upside risks creating asymmetrical risk preferences. This dislike of losses may be a cause of investor overreaction. The standard economic notion of risk aversion assumes symmetric risk preferences. Conservatism is the behavioral bias whereby investors react slowly to new information and is unlikely to cause overreaction.

References

Question From: Session 13 > Reading 46 > LOS g

Related Material:

- Key Concepts by LOS

Question #21 of 34

Question ID: 415237

If the efficient markets hypothesis is true, portfolio managers should do all of the following EXCEPT:

✓ **A)** Spend more time working on security selection.

✗ **B)** Minimize transaction costs.

✗ **C)** Work more with clients to better quantify their risk preferences.

Explanation

In an efficient market all stocks are properly priced and reflect all publicly available information. Therefore, individual selection of stocks is not important the only thing that is relevant is the portfolio's beta.

References

Question From: Session 13 > Reading 46 > LOS e

Related Material:

- Key Concepts by LOS

Question #22 of 34

Question ID: 415223

The value of an asset that a rational investor with full knowledge about the asset's characteristics would willingly pay is *best* described as the asset's:

✗ **A)** theoretical value.

✓ **B)** intrinsic value.

✗ **C)** market value.

Explanation

Intrinsic value is the price a rational investor with full knowledge about an asset's characteristics would willingly pay for the asset.

References

Question From: Session 13 > Reading 46 > LOS b

Related Material:

- Key Concepts by LOS

Question #23 of 34

Question ID: 415239

Under the efficient market hypothesis (EMH), the major effort of the portfolio manager should be to:

✓ **A)** achieve complete diversification of the portfolio.

✗ **B)** minimize systematic risk in the portfolio.

✗ **C)** follow a strict buy and hold strategy.

Explanation

In an efficient market, portfolio managers must create and maintain the appropriate mix of assets to meet their client's needs. The portfolio should be diversified to eliminate unsystematic risk. The appropriate systematic risk will depend on the clients risk tolerance and return requirement. Over time the needs of the client and environment will justify changes to the portfolio. The manager should also try to minimize transaction costs and at least try to match the performance of a benchmark.

References

Question From: Session 13 > Reading 46 > LOS e

Related Material:

- Key Concepts by LOS

Question #24 of 34

Question ID: 415247

If the momentum effect persists over time, it would provide evidence against which of the following forms of market efficiency?

✗ **A)** Weak form only.
✓ **B)** Both weak form and semistrong form.
✗ **C)** Semistrong form only.

Explanation

The momentum effect suggests it is possible to earn abnormal returns using market data. All three forms of market efficiency (weak form, semistrong form, and strong form) assume that market prices fully reflect market data.

References

Question From: Session 13 > Reading 46 > LOS f

Related Material:

- Key Concepts by LOS

Question #25 of 34

Question ID: 415220

Hume Inc. announces fourth quarter earnings per share of $1.20, which is 15% higher than last year. Hume's earnings are equal to the consensus analyst forecast for the quarter. Assuming markets are efficient, the announcement will *most likely* cause the price of Hume's stock to:

✗ **A)** increase.
✓ **B)** remain the same.
✗ **C)** decrease.

Explanation

An efficient capital market would price Hume's stock based on the expectation for earnings per share. Since actual earnings equal expected earnings, the stock price should not change as a result of the announcement.

References

Question From: Session 13 > Reading 46 > LOS a

Related Material:

- Key Concepts by LOS

Question #26 of 34

Question ID: 415231

The semi-strong form of efficient market hypothesis (EMH) asserts that:

✓ **A)** all public information is already reflected in security prices.

✗ **B)** both public and private information is already incorporated into security prices.

✗ **C)** past and future prices exhibit little or no relationship to another.

Explanation

Semi-strong EMH states that publicly available information cannot be used to consistently beat the market performance.

References

Question From: Session 13 > Reading 46 > LOS d

Related Material:

- Key Concepts by LOS

Question #27 of 34

Question ID: 415250

In behavioral finance theory, how is loss aversion *most accurately* defined? For gains and losses of equal amounts, investors:

✗ **A)** like gains more than they dislike losses.

✓ **B)** dislike losses more than they like gains.

✗ **C)** dislike for losses and like for gains are proportionate.

Explanation

Behavioral finance proposes that investors are loss averse. Loss aversion means investors dislike losses more than they like gains of the same amount.

References

Question From: Session 13 > Reading 46 > LOS g

Related Material:

- Key Concepts by LOS

Question #28 of 34

Question ID: 415236

Which of the following forms of the EMH assumes that no group of investors has monopolistic access to relevant information?

✓ **A)** Strong-form.

✗ **B)** Both weak and semistrong form.

✗ **C)** Weak-form.

Explanation

According to the strong-form EMH, security prices reflect all information, which includes the privately available (monopolistic) information.

References

Question From: Session 13 > Reading 46 > LOS d

Related Material:

- Key Concepts by LOS

Question #29 of 34

Question ID: 415229

The statement, "Stock prices fully reflect all information from public and private sources," can be attributed to which form of the efficient market hypothesis (EMH)?

✓ **A)** Strong-form EMH.

✗ **B)** Weak-form EMH.

✗ **C)** Semistrong-form EMH.

Explanation

This is the definition of the strong-form EMH. Private sources include insider information, such as persons holding monopolistic access to information relevant to the formation of prices.

References

Question From: Session 13 > Reading 46 > LOS d

Related Material:

- Key Concepts by LOS

Question #30 of 34

Question ID: 415245

Which of the following would provide evidence *against* the semistrong form of the efficient market theory?

✗ **A)** Trend analysis is worthless in determining stock prices.

✗ **B)** All investors have learned to exploit signals related to future performance.

✓ **C)** Low P/E stocks tend to have positive abnormal returns over the long run.

Explanation

P/E information is publicly available information and therefore this test relates to the semistrong-form EMH. Trend analysis is based on historical information and therefore relates to the weak-form EMH. In an efficient market one would expect 50% of pension fund managers to do better than average and 50% of pension fund managers to do worse than average. If all investors exploit the same information no excess returns are possible.

References

Question From: Session 13 > Reading 46 > LOS f

Related Material:

- Key Concepts by LOS

Question #31 of 34

Question ID: 415224

Which of the following would be *inconsistent* with an efficient market?

- ✗ **A)** Stock prices adjust rapidly to new information.
- ✗ **B)** Price changes are independent.
- ✓ **C)** Price adjustments are biased.

Explanation

Market efficiency assumes that investors adjust their estimates of security prices rapidly to reflect their unbiased interpretation of the new information. New information arrives randomly and independently. Therefore, price changes are independent.

References

Question From: Session 13 > Reading 46 > LOS c

Related Material:

- Key Concepts by LOS

Question #32 of 34

Question ID: 415217

An efficient capital market:

- ✗ **A)** does not fully reflect all of the information currently available about a given security, including risk.
- ✗ **B)** fully reflects all of the information currently available about a given security, excluding risk.
- ✓ **C)** fully reflects all of the information currently available about a given security, including risk.

Explanation

An efficient capital market fully reflects all of the information currently available about a given security, including risk.

References

Question From: Session 13 > Reading 46 > LOS a

Related Material:

- Key Concepts by LOS

Question #33 of 34

Question ID: 415225

A market's efficiency is *most likely* to negatively affected by:

- ✓ **A)** a ban on short selling.
- ✗ **B)** a high amount of trading activity.
- ✗ **C)** substantial analyst coverage of the exchange listed companies

Explanation

Research supports the conclusion that short selling helps to prevent market prices from becoming overvalued, while limiting short selling has the opposite effect. More analyst coverage and more liquidity contribute to market efficiency.

References

Question From: Session 13 > Reading 46 > LOS c

Related Material:

- Key Concepts by LOS

Question #34 of 34

Question ID: 485804

Octagon Advisors believes that the market is semi-strong efficient. The firm's portfolio managers *most likely* will use:

- ✗ **A)** an enhanced indexing strategy that relies on trading patterns.
- ✓ **B)** passive portfolio management strategies.
- ✗ **C)** active portfolio management strategies.

Explanation

If the market is semi-strong efficient, portfolio managers should use passive management because neither technical analysis nor fundamental analysis will generate positive abnormal returns on average over time.

References

Question From: Session 13 > Reading 46 > LOS e

Related Material:

- Key Concepts by LOS